



**Directorate of  
Intelligence**

~~Confidential~~

25X1

# Israel: Bleak Economic Outlook

25X1

**An Intelligence Assessment**

~~Confidential~~

*NESA 85-10011  
January 1985*

*Copy* 334

**Page Denied**



**Directorate of  
Intelligence**

**Confidential**

25X1

# Israel: Bleak Economic Outlook

25X1

**An Intelligence Assessment**

This paper was prepared by   
 Office of Near Eastern and South Asian  
Analysis. It was coordinated with the Directorate  
of Operations. Comments and queries are welcome  
and may be directed to the Chief, Arab-Israeli  
Division, NESAs,

25X1

25X1

25X1

**Confidential**

*NESA 85-10011  
January 1985*

Confidential

25X1

**Israel: Bleak Economic  
Outlook**

25X1

**Key Judgments**

*Information available  
as of 7 January 1985  
was used in this report.*

The national unity government tried to get off to a fast start in dealing with Israel's economic problems by announcing a large budget cut, a shekel devaluation, and higher gasoline prices after the first Cabinet meeting, but movement toward economic austerity quickly bogged down. Most ministers objected to cuts in their budgets, and a tentative wage-price deal fell apart within days. Under growing Israeli public pressure and wanting to demonstrate good faith to Washington, Prime Minister Shimon Peres became personally involved in the wage-price negotiations in late October, which quickly smoothed the way to an agreement. The Israeli Government, however, has yet to devise a comprehensive economic strategy that looks beyond the expiration of the wage-price freeze.

The Israeli Government will have to cut its budget by at least 5 percent if it is to begin a serious effort to resolve Israel's economic crisis. Beyond decisions on how much to cut from each ministry, the Israeli Government must find the political will to enforce such cuts. Most economists agree that, in conjunction with reduced spending, the Peres government must devise a system enabling the Bank of Israel to undertake independent monetary policies. In addition Israel must lower real wages, reduce the cost-of-living adjustment formula, and end the system under which wage patterns are based on interrelated agreements affecting a large number of labor unions.

Israeli leaders face a dilemma. The required economic remedies will force them to violate one, and probably both, of the guiding principles they have observed for more than a decade:

- High unemployment—anything above 5 percent—cannot be tolerated.
- Living standards should not be eroded.

We project that, if current trends continue, the financial gap (the sum of the civilian goods and services deficit, self-financed military payments, and debt repayment) will reach \$6.9 billion in 1987, compared with \$5.4 billion in 1983. Israel cannot cover a gap of that magnitude unless US aid is greatly increased or commercial bankers increase their exposure more than we believe is likely. Budget cuts of \$1 billion in 1985 and real wage declines of 5 percent in 1985 and 3 percent in 1986 would result in a financial gap of \$5.9 billion in 1987, entailing virtually no GNP growth and an unemployment rate of 10.5 percent. The Israeli Government probably could not find the foreign exchange to cover the financial gap even at this level. To reduce the financial gap to a manageable level—on the order of \$4.5 billion by 1987—domestic demand would have to be so constricted that the GNP would decline by 1 percent on average during 1985-87. Unemployment would reach 11.1 percent in 1987.

Confidential

NESA 85-10011  
January 1985

**Confidential**  

25X1

Confronting these dilemmas, Israeli officials will look to Washington to provide the foreign exchange needed to avoid making difficult economic choices. In addition to US funds for balance-of-payments support, Israeli officials want help in laying the groundwork for future economic growth, especially in developing high-technology industries. If the requested aid is not granted or is not sufficient to cover Israel's foreign exchange needs, Israeli officials eventually may ask for rescheduling or forgiveness of the \$9.5 billion owed to the United States.

25X1

**Confidential**

**Confidential**

25X1

**Contents**

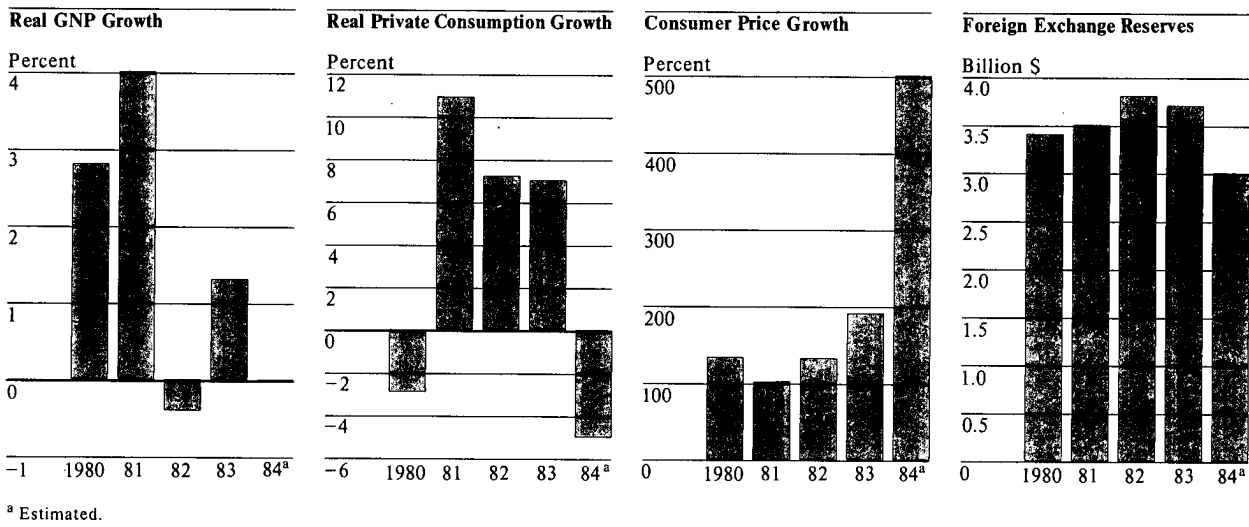
	<i>Page</i>
Key Judgments	iii
The New Government's Economic Actions	1
What Needs To Be Done	1
Political Constraints	2
If the Israelis Don't Bite the Bullet . . .	4
. . . and if They Do	4
Outlook	5
Implications for the United States	6

**Confidential**

**Confidential**

25X1

**Figure 1**  
**Israel: Economic Indicators, 1980-84**



304636, 1-85

25X1

**Confidential**

Confidential

25X1

## Israel: Bleak Economic Outlook

25X1

When Israel's national unity government was formed last year, one of its ostensible benefits was that it could deal decisively with the country's economic crisis, but that has not happened. Divisions within the Likud bloc, which holds most of the economic portfolios, have stymied economic policy making.

No Israeli leader wants to assume the responsibility for implementing policies that create unemployment or reduce the country's standard of living, particularly given the widespread perception in Israel that another parliamentary election may be held within the next year. As a result, Cabinet members have squabbled among themselves over policy initiatives, and the breathing space provided by the three-month wage-price freeze imposed last November has been squandered. The government nonetheless hopes that the steps it has taken will convince Washington to provide additional economic aid.

### The New Government's Economic Actions

The new government of Prime Minister Shimon Peres tried to get off to a fast start in dealing with the economy. At its first Cabinet meeting, the government approved in principle a \$1 billion cut in the budget, devalued the shekel by 8.3 percent, and increased fuel prices by 9 percent.

Movement toward economic austerity thereafter quickly bogged down:

- Objections by most ministers to reductions in their budgets have limited the size of the cuts actually approved and have stifled the ministers' willingness to implement the cuts.
- A tentative wage-price deal between the government and the Histadrut trade union federation, which represents about 90 percent of Israel's work force, fell apart within days.
- To give the appearance of doing something about the economy prior to Peres's visit to Washington, the government in early October imposed a six-month ban on the import of 50 luxury items—which will have only a marginal impact—and tightened foreign currency controls.

Under growing Israeli public pressure and wanting to demonstrate good faith to Washington, Peres became personally involved in the wage-price negotiations in late October. The talks had stalled because of Histadrut Secretary General Kessar's distrust of Finance Minister Modai, the previous government negotiator. Peres's longstanding friendship with Kessar—and traditionally close Labor relations with the Labor-dominated Histadrut—quickly smoothed the way to an agreement. According to the US Embassy, Histadrut leaders believe the agreement bolstered the leadership of Peres and Kessar, who faces Histadrut elections this year.

The agreement called for all prices to be frozen at their 2 November level through January 1985. Workers forfeited up to one-third of their December and January cost-of-living adjustments. They will be partly compensated by a 5-percent income tax credit for three months after the freeze is lifted. According to Finance Ministry and Manufacturers' Association sources of the Embassy, a "secret" appendix calls for reducing interest rates and continuing devaluation of the shekel at the anticipated rate of inflation.

### What Needs To Be Done

Economists generally agree that any serious attempt to solve Israel's economic problems must begin with drastic cuts in the government budget. We believe cuts of at least \$1 billion—5 percent of the budget—are required. Beyond decisions on how much to cut from each ministry, the government must establish an effective mechanism to enforce such cuts. Several times during the past two years, budget cuts have been approved by the Cabinet, but they did not materialize. Ministers have become adept at using "unanticipated" price hikes to justify higher outlays, and no minister has been penalized for overspending. The Finance Ministry Budget Director told the Cabinet in late December that only 15 percent of the cuts approved since the government took office in September had been implemented, according to the US Embassy.

Confidential



---

### ***The Economic Situation Facing the New Government***

*The immediate problem facing the national unity government when it took office in mid-September was a sudden large drop in the country's foreign exchange reserves (see figure 1). A drop of nearly \$700 million in reserves during July and another \$192 million decline in August sent shock waves through the Israeli financial community. Although the level of reserves was still sufficient to cover more than four months of civilian imports, the precipitous drop added to the uncertain economic climate.* [ ]

*In our view, the drop in reserves resulted from Israelis trying to hedge against the new government's anticipated economic austerity policies by converting their assets into US dollars. They remembered that the previous Likud government had denied plans to devalue the shekel during the weeks prior to a major devaluation in October 1983 and suspected that another devaluation was imminent. The foreign exchange controls adopted and gradually tightened after that devaluation encouraged an increasing number of Israelis to trade shekels for dollars on the black market.* [ ]

*The pressure on reserves came at a time when Israel's trade deficit was improving (see table 1). During the first eight months of 1984, the deficit was \$1.9 billion, \$600 million less than during the same period in 1983, according to Israeli statistics. The improvement was due to the more rapid depreciation of the shekel since October 1983, which made Israeli goods more competitive abroad and boosted the cost of imports in shekel terms. Reduced demand for imports because of the erosion of purchasing power from surging inflation, particularly in the first several months of the year, was also a factor.* [ ]

*Real wages plummeted during the fourth quarter of 1983 because the shekel's devaluation and the large October increase in government-controlled prices caused inflation to soar. Several wage increases to compensate for the higher prices, however, subsequently boosted real wages. By June, real wages were 27 percent higher than the low recorded in fall 1983, and wage agreements negotiated last summer provided an additional boost.* [ ]

---

Many economists contend that, in conjunction with reduced spending, the government must devise a system enabling the Bank of Israel to undertake independent monetary policies. Under present law and custom, the Bank is required to print enough shekels to finance the government's budget deficit. In the past, Bank officials have resorted to selective credit controls, but banks and companies have devised ways to get around them. [ ]

In addition Israel must lower real wages and reduce the cost-of-living adjustment. Real wage gains averaging 7 percent a year since 1976, which have resulted in part from the cost-of-living adjustments, have been instrumental in fueling Israel's inflation, which reached 500 percent last year. Under the terms of the November-January wage-price freeze, the cost-of-living adjustment was to be reduced for the duration of the freeze. To maintain real wage reductions over the long term, however, the government will have to engage in intensive bargaining with Histadrut leaders.

[ ]

The government must also end the system under which wage patterns are based on interrelated agreements affecting a large number of labor unions. For example, engineers' salaries are directly linked to those of teachers, and technicians' pay is linked to that of engineers. Such linkages make it difficult to channel Israelis into occupations that are short of workers, such as engineering, by increasing salaries for those jobs without creating wage spirals. [ ]

#### **Political Constraints**

The dilemma facing Israeli leaders is that the required economic remedies will necessitate violating one, and probably both, of the guiding principles they have observed for more than a decade:

- High unemployment—anything above 5 percent—cannot be tolerated.
- Living standards should not be eroded. [ ]

Judging from their public statements, a consensus apparently exists among key Israeli political leaders on the broad outlines of economic policy. That consensus includes a wage-price freeze, budget cuts, and no

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

Confidential

**Table 1**  
**Israel's Balance of Payments,**  
**1980-84**

Million \$

	1980	1981	1982	1983	1984 <sup>a</sup>
Civilian goods and services balance	-2,124	-2,195	-3,305	-4,109	-3,550
Exports	9,790	10,447	10,112	9,947	10,625
Goods	5,799	5,907	5,560	5,511	6,075
Services	3,991	4,540	4,552	4,436	4,550
Imports	11,914	12,642	13,417	14,056	14,175
Goods	7,326	7,251	7,336	7,765	7,600
Services	4,588	5,391	6,081	6,291	6,575
Self-financed military imports	250	-424	174	275	627
Military import payments	2,018	1,483	2,295	1,275	2,260
US military assistance	1,768	1,907	2,121	1,000	1,633
Debt repayment	1,025	1,152	1,053	970	1,250
Financial gap	3,399	2,923	4,532	5,354	5,427
Sources of financing	3,687	3,068	4,875	5,166	4,777
Unilateral transfers	1,474	1,583	1,421	1,305	1,125
US economic assistance	785	785	785	1,303	1,200
Israeli bonds	433	525	557	490	375
Other capital including short-term borrowing	989	146	2,175	1,265	2,077
Net foreign investment	6	29	-63	803	0
Change in reserves	288	145	343	-188	-650

<sup>a</sup> Estimated.

movement toward "dollarization."<sup>1</sup> Officials also agree on the need to move workers out of service jobs—particularly in the public sector—and into export industries. The consensus falls apart, however, when discussions get down to details and the setting of priorities—whose budget should be cut, by how much, which segments of Israeli society are better able to shoulder the burden, and how the poor and the disadvantaged are to be protected. [ ]

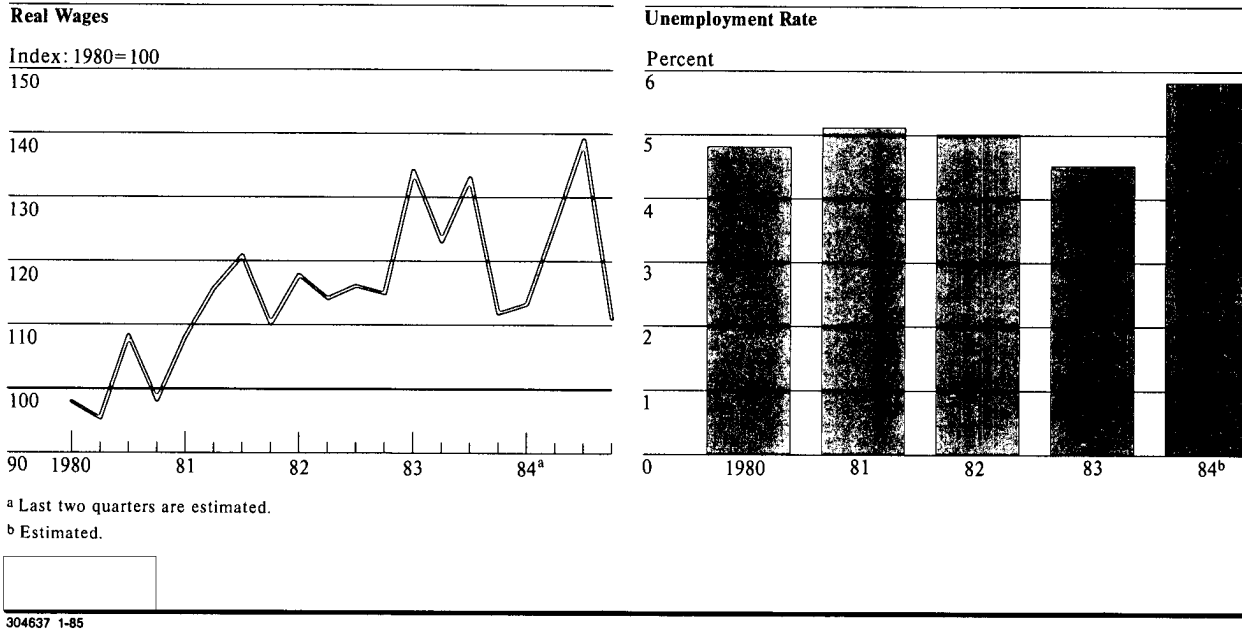
Wrangling among Likud leaders in charge of economic-related ministries has hampered economic policy making. Sniping by Herut ministers at Finance Minister Modai, who is chairman of the Liberal

Party, has led to Liberal threats to leave the Likud bloc and join the Labor Alignment. Deputy Prime Minister and Minister for Construction and Housing Levi has harshly criticized proposals for economic austerity because they are likely to hurt workers. Levi's populist image appeals to Israeli workers, and he probably intends to challenge Labor's hold on the Histadrut leadership during trade union elections this year. He is also maneuvering for advantage in the internal Herut power struggle. Minister of Industry and Commerce Sharon, a Levi rival, is also trying to attract worker support by campaigning against "exorbitant" price hikes. [ ]

<sup>1</sup> "Dollarization" refers to making the US dollar legal tender in Israel. [ ]

Confidential

**Figure 2**  
**Israel: Labor Market Indicators, 1980-84**



Looming over the Cabinet's deliberations on the economy is the prospect of an early parliamentary election. We believe the national unity government is unlikely to serve out its full 50-month term and could collapse within a year—a view widely shared in Israel. Because of the possibility of an early election, neither of the major parties wants to be blamed for tough, unpopular economic policies. In our view, each will try to put the onus on the other for any austerity policies that are implemented. [ ]

Histadrut leaders acknowledge the need for emergency measures but are coming under growing pressure from young union militants demanding more aggressive protection of worker interests. Kessar is up for reelection this year and, as a result, will be reluctant to support government proposals that could spark major divisions within the Histadrut. [ ]

#### **If the Israelis Don't Bite the Bullet . . .**

Using the CIA econometric model, we project that, if current trends continued, private consumption would grow at an annual average of nearly 4 percent through

1987, helping to produce GNP growth averaging 2.3 percent. The unemployment rate would reach 8.8 percent in 1987, compared with 4.5 percent in 1983. [ ]

Even though exports would grow faster than imports, a large increase in scheduled debt repayments would boost Israel's foreign financing requirements significantly by 1987. The financial gap<sup>2</sup> would reach \$6.9 billion, compared with \$5.4 billion in 1983. Israel cannot cover a gap of that magnitude unless US aid is greatly increased or commercial bankers increase their exposure more than we believe is likely. [ ]

#### **. . . and if They Do**

Budget cuts of \$1 billion in 1985 and real wage declines of 5 percent in 1985 and 3 percent in 1986 would result in a financial gap of \$5.9 billion in 1987, [ ]

<sup>2</sup> The financial gap is the sum of the civilian goods and services deficit, self-financed military payments, and debt repayment. [ ]

Confidential

**Table 2**  
**Alternative Israeli Economic Scenarios,**  
**1985-87**

	Change in Real GNP Growth (percent)			Change in Real Private Consumption Growth (percent)			Unemployment Rate (percent)			Financial Gap (billion \$)		
	1985	1986	1987	1985	1986	1987	1985	1986	1987	1985	1986	1987
Current trends	2.9	2.2	1.9	4.7	3.9	3.2	6.8	7.7	8.8	6.8	6.9	6.9
Austerity	0.5	0	0.1	2.8	1.3	0.7	7.1	8.6	10.5	6.0	5.9	5.9
Manageable financial gap	0.4	-1.5	-2.0	-4.5	-5.0	-5.5	7.1	8.8	11.1	5.8	5.1	4.5

\$1 billion less than would occur if current trends continue. This narrowing of the financial gap would entail virtually no GNP growth and an unemployment rate of 10.5 percent in 1987. The Israeli Government probably could not find the foreign exchange to cover the financial gap even at this level. [REDACTED]

To reduce the financial gap to what most economists consider is a manageable level—on the order of \$4.5 billion<sup>3</sup> by 1987—private consumption would have to decline at an annual average of 5 percent in 1985-87, and nonmilitary government consumption would have to decline by almost 2 percent annually. As a result, the GNP would decline by 1 percent on average during 1985-87. Unemployment would reach 11.1 percent in 1987. [REDACTED]

#### Outlook

The national unity government has yet to devise a comprehensive economic strategy that looks beyond the expiration of the wage-price freeze, and we expect officials will continue to resort to stopgap measures. Energy Minister Shahal told the US Ambassador that some ministers are convinced that the country's current economic problems are only transitory. [REDACTED]

Israeli officials, including Peres, have publicly stated that increased unemployment will not be the method

<sup>3</sup> We assumed that unilateral transfers of \$1.5 billion, Israeli bond sales of \$500 million, US economic aid of \$1.2 billion, and other capital inflows of \$1.3 billion annually would be available to cover the financial gap. [REDACTED]

used to deal with economic problems, and we believe that, if unemployment becomes much higher, the government will be unable to resist pressure to adopt expansionary policies. In an interview on 30 November, Finance Minister Modai said there might be a "marginal recession" and that only the present pockets of unemployment, although increasing slightly, will remain. [REDACTED]

Modai will probably propose more cuts for the FY 1985 budget, which begins on 1 April. A comprehensive agreement on the cost-of-living formula and real wages, however, is unlikely. We believe that Histadrut officials, particularly as the trade union election approaches, will be under tremendous pressure to recoup real wage losses, estimated by the US Embassy at 20 percent, incurred during the November-January freeze. Histadrut officials see little chance to reconcile the realities of economic austerity with rank-and-file pressures to maintain the existing standard of living, according to the US Embassy. [REDACTED]

Institutional reforms affecting the tax system or monetary policy will probably not survive the coalition's political squabbling. Powerful banking and other vested interests can probably play factions within the national unity government against each other. [REDACTED]

Confidential

**Confidential**

Israeli officials are presenting unrealistically optimistic public assessments. For example, Peres has predicted that the inflation rate can be brought down to 10 percent in one year. Peres and others have talked about exports that will provide long-term economic growth. Israel's high-technology products are viewed as the most promising area for export growth and the source of future jobs. High technology, however, will not be the panacea that the Israelis hope it will, in our view.<sup>4</sup> We believe that Israeli officials want to hold out the prospect of imminent good economic times to make current bad news politically more palatable.

[REDACTED]

#### **Implications for the United States**

Israeli officials will look to Washington to provide the foreign exchange needed to avoid making difficult economic choices. If the requested aid is not granted or is not sufficient to cover Israel's foreign exchange needs, we believe that Israeli officials eventually may ask for rescheduling or forgiveness of the \$9.5 billion owed to the United States.

[REDACTED]

In addition to US funds for balance-of-payments support, Israeli officials want help in laying the groundwork for future economic growth. The Joint Economic Development Group agreed to during Peres's trip to Washington in October is viewed by the Israelis as a way to promote economic development in Israel. Israeli officials want a mechanism for channeling US funds into Israel that can be used, for example, to develop high-technology industries.

[REDACTED]

[REDACTED]

Israeli officials are already sensitive to charges in the Israeli press that the United States is dictating the coalition's economic policy. Israeli officials will contend that the United States in the past has cited as the only criteria for determining aid levels the condition of the Israeli economy and Israel's military requirements. They will argue that Israel's economic crisis requires large additional infusions of US assistance. They will resist any attempt to condition additional aid on either the economic policies they pursue or political considerations, such as movement on the peace process.

[REDACTED]

25X1

25X1

25X1

25X1

25X1

**Confidential**

**Confidential**

**Confidential**